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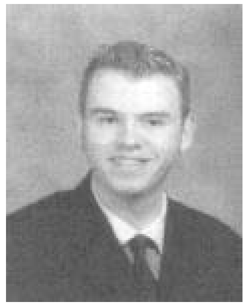

Introduction

Since the founding of the European Community, the world has watched in amazement as the unspeakable unfolded. Europe, once the center of an almost constant state of war, through a series of diplomatic and political achievements has slowly unified into a cohesive economic and political union, albeit a loose one. Perhaps the most remarkable of these achievements is the introduction of a common currency. This step has been carefully watched by financial, economic and political observers, as it is the first such experiment of its size. With the formation of the European Monetary Union (EMU), the currencies of eleven countries were fused into a common unit. Much attention has been given to the effects that this change will have on the larger economies of Europe, such as Germany and France. My discussion, however, is aimed at examining the euro from the perspective of one of its smallest members, Ireland.

To understand what the euro will mean for Ireland, one must examine the history of currency in Ireland. Indeed, the history of Ireland is a history of monetary union. Once a clear understanding of Ireland's past monetary policy is established, the current monetary union will be examined. I will use the framework of optimal currency theory to address the question of whether the net effect of joining the EMU will be positive or negative for

Ireland. Finally, I will examine the unique challenges Ireland faces, especially those resulting from the UK's nonparticipation in the euro.

A Legacy of Monetary Union

The economic history of Ireland is largely the story of Ireland's struggle for independence from the control of Great Britain. Over the course of the last century, Ireland has evolved from a largely agrarian hinterland of the rich and powerful British Empire to an independent, open industrial economy. With each passing year, Ireland drifts farther from its economic heritage of dependence upon Britain and grows ever-stronger economic ties to Europe. The adoption of the euro represents an important step in this long process of independence.

To fully understand the significance of the euro for Ireland, one must first understand the monetary background of the country. For centuries Ireland was part of the political and monetary union known as the United Kingdom. Thus, until 1922 all Irish trade was conducted in the British pound sterling. Indeed, it should be stressed that Ireland's monetary history is largely a story of monetary union, not monetary independence. It was not until several years after independence that Ireland even nominally established its own currency. Although the Currency Act of 1927 nominally established an Irish currency, that currency was fully backed by British sterling securities. In fact, until 1961 Irish banknotes were marked "payable in London." (O'Hagan, p.29) Parity with sterling was the most logical policy in these early years of the Irish Republic, as most of Ireland's trade during this period was with Great Britain. However, the parity policy made the Irish currency, called the punt, a mere shadow of the pound sterling with no independent monetary policy. It implied that the growth of the Irish economy would be limited by Britain's rate of growth and that inflation would be "imported" from the former mother country.

During the early decades of political independence, the desire for independence in all areas encouraged a policy of economic isolationism. When Fianna Fail became the controlling political party in 1932, it initiated an economic policy that was ideologically committed to greater economic self-sufficiency. (O'Hagan, p.30) The main economic means of asserting this self-sufficiency was through the levying of tariffs. Though generally seen as poor economic policy today, import duties were standard practice in an era dominated by worldwide depression. The intention of these tariffs was to protect domestic industry from international competition, thus protecting industrial jobs. Economists today agree that tariffs tend to encourage inefficiency in protected industries and result in generally higher price levels. However, in the 1930s tariffs were seen as a valid policy response to an economic crisis. The spirit of protectionism dominated the Irish political landscape until after the Second World War. Irish economic performance during this period was dismal; in fact, according to O'Hagan "during the war, real GNP fell, especially initially. Living standards fell further as households, unable to find the goods they wanted, were obliged to save more." (O'Hagan, p.33) Though the end of the war brought some improvement in economic activity, Ireland failed to recover at a rate similar to that of the rest of Europe. During this entire period, Ireland's currency was backed one-for-one with the pound sterling.

By the late 1950s, the Irish government began to recognize the need for change. Largely through the influence of a report by respected Irish economist T.K. Whitaker, measures for economic improvement were introduced in 1958 through the First Programme for Economic Expansion. The program was a much needed catalyst for change, and economic growth reached four per cent per annum. (O'Hagan, p.36) The details of this plan required the government to reduce protective tariffs on most industries and resulted in a far more open economy.

The Road to Euro

In 1973 Ireland joined the European Community (EC), today called the European Union (EU). This represented an important symbolic step towards economic independence, for although the UK also joined at the same time, Ireland joined as a peer of its former mother country. Furthermore, the terms of the EC trade agreements meant that Ireland would have significant advantages in trading with other EC countries. These agreements naturally increased the amount of trade between Ireland and the other EC countries, making Ireland less dependent on Britain as its primary market. Economist Dermot McAleese addressed this issue in a speech at the Institute on European affairs. He suggested that as the patterns of trade shifted, it became clear that membership in the European Community had "encouraged market diversification away from the UK towards the faster growing continental economies…. The reduction in Irish links with, and dependence upon, the slow-growing British economy was seen as having a 'liberating' effect on the Irish economy." (McAleese) This, however, did not imply that the structural changes brought about by EC membership would be without cost. McAleese notes that it was generally acknowledged that entry into the EC brought "two negative effects, the loss of (the Irish) preferential position in the UK market and the exposure of Irish business to the full rigours of European competition." These negative effects were largely offset by gains from trading with Europe tariff-free.

During its early years of EC membership, the UK experienced high rates of inflation. By virtue of the parity of the punt with sterling, Ireland imported most of this inflation as well. The desire to escape the highly inflationary sterling zone contributed to Ireland's eagerness to embrace the European Monetary System (EMS), an agreement that linked the exchange rates of the EU countries. The EMS limited the variation in relative values of currencies to a small percentage above or below a target value. The goal of the EMS was to greatly reduce exchange rate risk[1] within the European Community. In order to join the EMS, Ireland had to end the policy of parity with sterling, which it did in 1979.

From the break with sterling in 1979 to the launch of the euro in 1999, the Irish punt floated in a system of flexible exchange rates relative to sterling and other world currencies. It was in this period that the Irish central bank had its greatest autonomy. This is not to suggest, however, that Ireland's monetary policy was not influenced by the policies of other central banks or that the Irish Central Bank (ICB) was able to confine itself to considering only the domestic economy in making monetary decisions. Indeed, the policies of the Bundesbank and the Bank of England continued to have a significant effect on Ireland. The ICB was said to have "twenty minutes of autonomy," (Kavanagh) because that was about how long it had to react when the Bundesbank raised or lowered the interest rate. Because the EMS was functionally similar to a fixed exchange rate, it

[1] Exchange rate risk arises from the fact that international trade requires the exchanging of currencies whose relative values are not always the same. Within a system of floating exchange rates, "international business involves foreign exchange risk since the value of transactions in different currencies will be sensitive to exchange rate changes." (Melvin p. 99)

allowed for relative ease of capital flows throughout Europe. Funds could be moved from one country to another in search of the highest interest rates. Thus, low-interest-rate countries faced a risk of substantial investment loss or depreciation. To prevent such leakages, the smaller economies of the EMS were forced to follow the leader, Germany, in terms of monetary policy. Following the German reunification in the early 1990s, this policy proved to be dreadfully inappropriate for the other countries of Europe. The Bundesbank kept interest rates high to fight inflation in Germany, but the rest of Europe was recovering from recession and needed lower interest rates. The deutschmark appreciated substantially as a result, and this disparity caused the EMS to all but disintegrate. The narrow bands that defined the system were widened substantially, thereby allowing for greater exchange rate fluctuation and defeating the purpose of the whole system.

In spite of the breakdown of the EMS, plans for European Monetary Union (EMU) proceeded on schedule, and the euro arrived somewhat uneventfully on January 1, 1999. However, the euro's subsequent substantial depreciation vis-à-vis the dollar has prompted some to suggest that the euro may have been a mistake. To make this determination, however, one must examine the arguments originally used to justify participation in EMU. The following sections present the theoretical foundation upon which the concept of international currency union is based. In light of these arguments, one can assess the decision to fuse the national currency and that part of the national identity it represents into the larger EMU and the larger Europe.

Currency Area Theory

A national currency is naturally associated with national sovereignty. Thus, the notion of a country, or set of countries, giving up their separate currencies in favor of a combined, super-national currency seems peculiar. The suggestion, for instance, that the United States or Canada might give up their dollars or Japan her yen would seem preposterous. This is largely because the notion of a national currency is such an important political idea. In economic terms, however, a currency is just a tool of trade, and it does not matter what one calls it or who manages it, as long as it performs the basic functions of a currency. It must serve as a unit of account, a store of value, a medium of exchange and a means of deferred payments.

In 1961 Nobel Prize laureate economist Robert Mundell posed the unthinkable in his paper "A Theory of Optimum Currency Areas": that the borders of a currency area might not necessarily coincide with national borders (Mundell, p. 663). Instead of politics, he asserted that economic criteria should determine who uses what currency. It is largely as a result of this work that the concept of monetary union gained credibility in economic circles, and people the world over began to scrutinize their currencies, asking the question "What is the optimum size currency area?" Though for most of the world such questioning was mere academic speculation, such was not the case for Europe. There the winds of political change had led to the creation of the European Union, and the answer to this currency question led to action. Indeed, the creation of the euro is a phenomenon never before seen: eleven sovereign nations willingly fusing their currencies into a common unit. It is a tremendous political feat and a grand economic experiment.

The question of whether Ireland should have joined the EMU is largely a political one. To the degree that it is an economic issue, however, debate centers on the question of whether Ireland is an optimum currency area. To address this question I turn to Mundell, whose seminal article discusses the question of what criteria determine the optimum currency area. He argues that it is not the nation but the region that should be the primary economic unit considered. He concludes that "if the world can be divided into regions within each of which there is factor mobility and between which there is factor immobility, then each of these regions [is an optimal currency area and] should have a separate currency, which fluctuates relative to all other currencies." (Mundell, p. 663) Factor mobility must exist within a currency area for that area to be considered a cohesive economic unit. However, external factor mobility must be minimal, lest outside influences lead to profound internal economic effects. Thus, in Mundell's terms Ireland would be an optimal currency area if it could be defined as a region by his factor mobility criterion.

If Ireland herself is an optimal currency area, then the adoption of the euro involves moving away from an economically optimal situation and will prove to have costs that outweigh its benefits. However, if Ireland is a smaller-than-optimum currency area – that is, if it is not a whole region, but rather a subset of a larger region as defined by Mundell – then the adoption of the euro should bring some net benefit to Ireland. This holds true even if the whole Eurozone is a larger-than-optimal currency area. For the sake of this discussion I will ignore the possibility that Ireland is too large to be considered an optimum currency area, as that is highly unlikely. This will enable me to ignore questions of internal factor mobility and to concentrate on external issues.

Factor Mobility Criteria

It is possible to argue that Ireland is a smaller-than-optimum currency area based on the factor mobility criteria because evidence exists that external factor mobility is significant. That is, movement of labor and capital into and out of Ireland is more similar to the level of mobility common within countries than across international borders. One component of factor mobility is a flexible labor market. While a general lack of labor mobility is a problem throughout much of Europe, Ireland seems to be better off in this regard than some of her continental partners. Evidence of this fact is Ireland's legacy of emigration. Throughout its history, the Irish labor market has often made use of this "exhaust vent" to reduce unemployment. Though the most dramatic example of this was during the potato famine, when literally millions fled the country, the pattern of emigration continued almost uninterrupted until the 1990s. In 1996 the pattern of emigration was reversed, however, and Ireland began to experience net immigration. In 1999 net immigration was approximately 18,500 persons, or roughly 0.5 percent of the Irish population. (Irish Centre for Migration Studies) Migration has played an important role in stabilizing the Irish economy: during much of Ireland's history outward migration served to relieve unemployment pressure. However, today inward migration is serving to relieve the worker shortage and fuel Ireland's remarkable expansion. This would suggest that the Irish labor market is open and external labor mobility is significant. If Ireland were an entire region, by Mundell's standard, one would expect little or no external labor movement. Indeed, the whole premise of stability in the regional currency area rests upon the necessity of currency valuation to help to eliminate unemployment and control inflation. Since Ireland relies upon significant movement of labor across its borders to stabilize its economy, it would seem that Ireland is not an optimal currency area. Contrary to this justification of Irish membership in the EMU, however, is the general lack of wage flexibility in Ireland. This wage inflexibility results from the long-term wage contracts that are negotiated among government, unions and employers on a national level every three years. These long-term contracts hinder the flexibility of the labor market and make economic adjustment more costly. Because wages are set for several years, intermediate wage adjustments are not available to relieve wage pressure.

While labor mobility is an important element of Mundell's theory, labor mobility alone is not enough to determine if a currency area is optimal. Capital must also move through the economy to where it can be most efficiently used. Capital mobility within Ireland is relatively high, in part due to the high level of concentration of the Irish financial services sector. A small number of banks dominate the retail banking industry in Ireland, providing cohesion that a fragmented market might not. The extent of this domination is seen in the five-firm domestic retail-banking market concentration ratio, which for Ireland was nearly 100 percent in 1997, higher than any other EU member. (Hutchinson, p.4) That is, the top five Irish banks share nearly 100 percent of the Irish banking business. While this concentration may at first seem a hindrance to capital mobility within Ireland, one must acknowledge that in banking, unlike other industries, concentration often contributes to liquidity by providing a national money market. Finally, the high level of concentration has created a situation in which the largest Irish banks are too big to operate only in Ireland. Thus, these large lenders have built international operations to compete in the world market, thereby indicating that the borders of the Irish money market are open.

This brings me to my next point. If capital can move freely within Ireland as well as into and out of Ireland, it is safe to say that Ireland has an open capital market and a high degree of capital mobility. Indeed, McAleese notes that international capital mobility has increased in the years following the Single European Act of 1987, although capital controls between Ireland and the other EU countries remained in place until the early 1990s. He concludes that "the abolition of capital controls means that Irish capital is [now] free to go where it can make the highest return and diversify risk. This freedom to borrow and lend abroad has brought economic benefits to Irish individuals and Irish companies by enabling them to diversify their portfolios and maximize the return on capital." It should be further noted that until 1979 the policy of parity with sterling allowed for, and indeed encouraged, capital mobility between Ireland and the U.K. After 1979, the European Monetary System facilitated, if not encouraged, greater capital mobility throughout Europe by ensuring that exchange rates would remain within small bands. Thus, the high degree of capital mobility into and out of Ireland can be seen as external mobility. According to Mundell's theory this supports the argument that Ireland is probably not an optimal currency area.

Other Optimal Currency Theories

Mundell was not alone in addressing the question of optimum currency areas. American Economist Ronald I. McKinnon added to the discussion with his 1963 paper "Optimum Currency Areas," in which he develops the idea of optimality by discussing the influence of the openness of the economy. (McKinnon, p.717) He argued that open economies are less likely to benefit from a system of flexible exchange rates and are therefore less likely to be considered optimal currency areas. The reason is that variations in the prices of imported goods have a greater effect on domestic price levels in an open economy than in a closed economy. McKinnon summarized his argument by stating, “As we move across the spectrum from closed to open economies, flexible exchange rates become both less effective as a control device for external balance and more damaging to internal price level stability.” (p.719) This would suggest that for open economies, a policy of fixed exchange rates would be more conducive both to foreign trade and to domestic price level stability.

McKinnon’s argument is compelling in the case of Ireland, as the Irish economy has an exceptionally high degree of openness. Perhaps the most convincing evidence of this is the high proportion of the Irish economy engaged in international trade. According to the Central Statistics Office of Ireland, exports amounted to 75 percent of GDP in 1995 and imports 60 percent. While international trade alone does not preclude a country from having its own currency, it complicates the currency question by increasing the economy’s overall exposure to exchange rate risk. As McKinnon illustrated, open economies face greater risks of domestic price level volatility in a flexible exchange-rate regime than their less open counterparts. An example will serve to illustrate this point.

Since changes in the monetary policy of Ireland’s various trading partners can affect the rates of inflation and investment in those countries, these changes can also affect the Irish economy. A low rate of inflation in Germany, for instance, could make Irish goods less competitive since they would begin to be relatively more expensive. Likewise, German imports would become less expensive and therefore more competitive in Ireland; thus both import and export activities are affected. Though a flexible exchange-rate mechanism might serve to offset some of these changes, it must be recognized that such effects can be both help and hindrance. In the above example, one would expect the deutschmark to appreciate relative to the Irish punt, thus offsetting some of the price difference. To Ireland, however, this change would be a gain in competitiveness but a loss in purchasing power. Whereas a fixed exchange-rate regime would have given Irish consumers a lower price level and perhaps would have helped to offset domestic inflation, the flexible exchange-rate regime has closed the gap, making Irish goods more competitive but leaving prices relatively high in Ireland.

For a country less dependent on international trade, these currency changes would be of less concern since much of the economy is engaged in production for domestic consumption. For Ireland, however, a change in the exchange rate can have far wider effects, since such a great proportion of the economy is engaged in international trade-related activity. Thus, a free floating punt poses a significant risk to Irish employment and price level stability.

Costs to Ireland

Most supporters of Irish participation in the EMU do so because they believe Ireland will be better off in the EMU than outside. This belief is largely based on the conclusion that Ireland is a smaller-than-optimal currency area. If this is the case, then it is assumed that as part of a larger currency area Ireland will adjust more quickly to economic shocks, such as a sudden rise in unemployment. However, there are a number of arguments that suggest this is not the case. Rather, these arguments suggest that the switch to the euro will come at great cost, especially where adjustments to asymmetric shocks[2] are concerned. A study conducted by University of Cork Economist Liam Gallagher examined the correlation of macroeconomic shocks between Ireland and the U.K. as well as between Ireland and Germany. The results of his study indicated "that Ireland is presently not in an optimum currency area with either Germany or the U.K. Moreover, because of inflexible relative wages in Ireland due to national wage agreements and barriers to labor mobility, Ireland as a member of the EMU faces increased cost of adjustment to macroeconomic shocks." (Gallagher, p.943)

The EMU will present additional challenges for the Irish economy to overcome. The most significant of these costs relate to the U.K. remaining outside of the Eurozone. Though its trading importance to Ireland continues to diminish, the U.K. is still one of Ireland's most important trading partners. Ireland as a member of the EMU faces increased exchange risk in its trading with the U.K. because it is expected that changes in the exchange value of the euro will not be as closely correlated to changes in sterling as were changes in the Irish punt. Furthermore, Ireland faces the unique situation of being an island of two currencies. Though this is not new with the introduction of the euro, as mentioned previously, the Irish and British pounds tended to move together. Though parity ended in 1979, thus ending their interchangeability, movements in the values of the two currencies have remained similar. This relationship was of particular importance in those areas of Ireland where both currencies are used. The expectation that sterling and the

[2] Asymmetric shocks are economic events the effects of which vary from one region to another or one country to another. These shocks complicate macroeconomic policy by exaggerating the effect of the event in some areas relative to others. Since most macroeconomic policies must be applied evenly throughout the economy, asymmetric shocks are especially difficult to remedy.

euro will be more divergent than were the punt and pound will likely make life more difficult in the border region and add to the cost of north-south trade.

From the perspective of trade, the EMU will be advantageous to the Irish punt only to the extent that Ireland trades with Europe. Exchange-rate risk will be reduced vis-à-vis Europe, and some increase in exchange rate risk is expected with respect to the U.K., so long as it remains out of the EMU. In recent years, the significance of trade with the U.S. has increased significantly, and the euro is not expected to be beneficial to this trade. Although recent weakness in the euro-U.S. dollar exchange rate would be expected to benefit Ireland's trade balance, the true effect is as yet unclear. Since the introduction of the euro, Irish exports have increased dramatically; however, these increases are not as spectacular as in prior years. For example, in 1998 exports increased approximately 27.7 percent over 1997, while in 1999 exports rose just 15.6 percent over 1998. Similarly, the trade balance surplus rose 46.6 percent in 1998 while rising 28.4 percent in 1999. (Central Statistics Office). Though these numbers still represent stunning growth, the reduction in export growth and overall trade balance growth are contrary to what one would expect given the weakness of the euro. Obviously, there must be other economic factors that obscure the role of the common currency in the balance of trade.

Finally, one must also acknowledge that in joining the EMU, Ireland has forfeited what little monetary autonomy it had. This forfeiture is an interesting tactical move considering how important independence has been to the Irish national experience. Sacrificing autonomy means that devaluation is no longer an option to policy makers. From a risk-reducing standpoint, this is a positive effect, but it means that the Irish have less control of their own economy than they did before joining the EMU. Additionally, the

Irish central bank will no longer set interest rates for Ireland, as interest-rate policy will come from the European Central Bank in Frankfurt.

Conclusions

Debate continues as to whether the Irish will benefit from joining the EMU or if they will suffer. One can certainly not ignore the fact that the Irish are culturally more similar to the people of Britain or the U.S. than to Europe. This culture affects the pattern of consumption within the Irish economy and consumption drives economic growth. Thus, one can assume that as long as cultural differences persist, some economic divergence will remain. The relevant question, however, is to what extent this divergence will be significant. Furthermore, one must address the question of whether the divergence is still more desirable than the added costs of a flexible exchange-rate.

As a small, open economy, Ireland faces higher costs of doing business than larger less open economies. In a floating exchange-rate regime, these costs come in the form of transaction costs and exchange-rate risk. In a fixed exchange-rate regime or in the extreme case-- a monetary union-- these costs arise from the cost of adjustment to asymmetric macroeconomic shocks. Because economists are denied the luxury of laboratory experiments enjoyed by their natural science counterparts, it may never be possible to answer this question with certainty. However, as the above discussions have illustrated, one can make a strong case that Ireland is not an optimal currency area. As such, enlarging the "Irish" currency area should produce some net benefit for Ireland, even if the whole Eurozone is not an optimal currency area. Finally, it must be acknowledged that the cost of membership in the EMU would be significantly less for Ireland if the UK were also a member. Britain's absence from the Eurozone can be expected to add to the cost of adjustment of the Irish economy to the euro as well as exposing Ireland to ongoing currency risk.

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Biography

Timothy J.P. Doherty graduated with highest honors from Lehigh University in January of 2001 with a Bachelors of Arts degree in Economics and Urban Studies. While at Lehigh, he was elected to Phi Beta Kappa, Omicron Delta Epsilon and Phi Eta Sigma honor societies. He is a two-time winner of the Williams Prize for writing and a published poet. As an undergraduate, Tim participated in the Roy C. Eckardt College Scholar Program in the College of Arts and Sciences. He was awarded Departmental Graduation Honors in Economics and a Presidential Scholarship, with which he is currently pursuing a Master's degree in Economics.

Abstract

This paper addresses the issue of European Monetary Union (EMU) from the Irish perspective by examining the monetary history of Ireland, the theoretical underpinnings of EMU and the unique challenges faced by Ireland as a member of the EMU.